Appendix H

OVERVIEW OF THE 2004 NORTH CAROLINA STATE LOW-INCOME HOUSING TAX CREDIT PROGRAM

Fundamental Change

The new state tax credit ("STC") is different from the federal low-income housing tax credit ("LIHTC") and the state credit in effect prior to 2003 in that it is not an investment. There is no "sale" of the credit, no limited partner equity, or any of the other features of a tax-shelter investment. The program is administered by the NC Housing Finance Agency ("Agency") in conjunction with the NC Department of Revenue ("DOR"), and only developments with a 2004 LIHTC award are eligible. (The program is also authorized for 2005 but may be subject to different requirements.) Projects using tax-exempt bond financing are not eligible.

Ownership Entities

The federal LIHTC flows from qualified low-income building(s) to the owner, which is either a limited liability company or limited partnership ("LLC/LP"). These entities are owned by members or partners (respectively). LLC/LPs are known as "pass-throughs" because all federal and state income tax events (such as profits, losses and credits) pass through to the members or partners. The LLC/LP essentially does not exist from an income tax perspective. Rather, the members/partners receive the LIHTC, and in exchange for the right to offset tax liability will invest equity. The ratio or "price" is typically $0.75 invested for every dollar of offset.

The new STC is an exception to this practice. Under the state statute (the text of which is included at the end of this Appendix), no STC flows from the LLC/LP to its members/partners. In every case the credit is either:

- claimed directly by the pass-through entity or
- transferred to the Agency.

The first of these is commonly referred to as the "direct refund" or "grant" option, and the latter as the "Agency loan" option.

Calculation of STC Amount

The new STC is 10%, 20% or 30% of the development's eligible basis, which is the total cost to construct the buildings less items not subject to depreciation (such as land and reserves). For the purposes of the STC, the amount of eligible basis is determined as a part of the carryover allocation process and does not change thereafter. For 2004 applications the basis amount is in Line 57 on the Project Development Cost page.

The STC percentage depends on the development's location. Pursuant to state statute the Agency has designated each county as High, Moderate or Low Income, which corresponds to the 10%, 20% and 30%. (The county list can be found in QAP Section II(D), page 3.) For example, a 48 unit development in a Moderate Income county with $3,360,000 in eligible basis would be eligible for $672,000 in STC.

Income Targeting Standards
An award of federal LIHTCs does not necessarily entitle an LLC/LP to claim the STC. The state statute goes beyond the federal targeting requirement (households at 60% of area median income) with more restrictive limits based on the county income designation.

High Income county (two options):

- Fifty percent (50%) of the qualified residential units are affordable to households whose income is forty percent (40%) or less of the area median income.
- Twenty-five percent (25%) of the qualified residential units are affordable to households whose income is thirty percent (30%) or less of the area median income.

Moderate Income county: Fifty percent (50%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of the area median income.

Low Income county: Forty percent (40%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of area median income.

Making the Refund/Loan Election
As part of the full application for LIHTCs, LLC/LPs are required to indicate which of the two options for taking the STC they will elect. This choice will be based on a number of factors, many of which will be unique to a particular development team. Regardless of the circumstances, program participants will need to consult with professionals (i.e. attorneys and accountants) who are familiar with the STC and related legal issues. Federal LIHTC equity investors may also have an interest in the election.

The following chart describes the major distinctions between each option, which are further described in the remainder of this Appendix.

Direct Refund	Agency Loan
Project must be 50% complete, inspected and meet all requirements before funds may be issued from escrow	Can close when the construction financing equals the loan amount and the Agency has received the funds
Subject to automatic, statutory recapture and penalties for non-compliance	Exempt from statutory recapture; compliance covered by the loan documents
Value will become partners' equity	Will be subject to repayment in year 30
Will result in federal taxable income recognition for partners	Excluded from federal income taxes if within terms of the private letter ruling

The form carryover agreement will have a section for project owners to elect the loan or direct refund method. However, any indication that is contrary to the representation made in the full application will result in revocation of the tax credit award.

Direct Refund (Grant) Option
The LLC/LP may choose to receive a refund of the STC amount. Under this method the DOR will issue funds in the name of the LLC/LP to an escrow account held by the Agency. The account can only be closed when the development meets certain milestones. The most important of these is that at least half of the activities to be included in the project's eligible basis must be completed (see QAP Section VII(B)(2) for a complete description). The purpose behind these limitations is to ensure that resources are not claimed ahead of corresponding value being created in the buildings.

If an LLC/LP accepts a refund and subsequently fails to ensure that the development complies with the relevant requirements under the statute and QAP, its members/partners and related parties will be liable for recapture of the refund amount, in addition to other penalties (as determined by the Agency and DOR).

Regardless of the circumstances, a project cannot reflect payment of taxes owed due to electing the direct refund method. Any amount owed by a member or partner will be their responsibility and may not be included as a development cost, cash flow priority, reduced equity pricing or otherwise. This limitation will apply to all stages of the Agency's project review (i.e. application, carryover and final cost certification).

Agency Loan Option

The loan will be 0% interest, thirty year balloon (no payments), unless the members/partners desire to have more stringent terms. There is no requirement that 50% of the basis-eligible activities be completed prior to closing the loan. The only timing-related limitations are that:

- the funds must be used to pay down the existing construction financing (using the earlier example, the LLC/LP must have borrowed at least $672,000),
- the project must otherwise comply with the QAP, and
- the Agency must have received the funds from the state treasury.

As of the present time, half of the funds will be issued after July 1, 2005. Therefore the first disbursements of loan proceeds will not be until after that date and will be for no more than half the total amount of a loan. The other half will be issued after July 1, 2006. This timing of when funds will be available is subject to change.

The private letter ruling ("PLR") applicable to the loan option is available on the Agency website: http://www.nchfa.org/pub/rental/IRS_Information.pdf

The premise for the PLR is that the Agency will not have to provide an information return to ownership entities that have elected to receive the loan. The PLR holds that a recipient of a loan neither receives nor becomes entitled to receive a state credit for purposes of Section 61 and 451 of the Internal Revenue Code. The result of this conclusion is that the recipient of a loan does not receive and subsequently transfer its STC exchange for a loan. Accordingly, the transaction is treated for federal income tax purposes as a direct state loan to the recipient. No gain is recognized as a result of a deemed transfer of credit. The receipt of a loan from a state entity, even with a below-market interest rate, is not subject to federal income tax.

To achieve this federal income tax treatment, the loan must constitute indebtedness for federal income tax purposes; that is, the fair market value of the property exceeds the total amount of the indebtedness to which the property is subject and the ownership entity reasonably expects to repay the full amount of the loan in accordance with its terms.

There is also no possibility of statutory recapture under this option. Instead, failure to comply will be addressed by the Agency. This may include foreclosure of the loan and/or penalties applied to future applications for Agency funding.

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SELECTED EXCERPTS OF THE
2004 QUALIFIED ALLOCATION PLAN

VII. POST-AWARD PROCESSES AND REQUIREMENTS

B. STATE TAX CREDITS

As the administrative agent for state credit refunds issued under N.C.G.S. § 105-129.42, the Agency has a responsibility to ensure that ownership entities do not receive resources ahead of corresponding value being created in the project. Therefore the following restrictions will apply to the state tax credit refund program.

1. Loan Option: Loans made by the Agency pursuant to N.C.G.S. § 105-129.42(d) will not be closed until the outstanding balance on the first-tier construction financing exceeds the total state credit amount; the entire loan must be used to pay down a portion of the then existing construction debt.

2. Direct Refund Option: The Agency and ownership entity will enter into an escrow agreement with regard to the refund dollars. The agreement will state, among other reasonable limitations, that issuance of the funds under N.C.G.S. § 105-129.42(g)(1) will not occur until all of the following requirements have been met:

    (a) at least fifty percent (50%) of the activities included in the project's eligible basis have been completed;

    (b) the Agency and local government inspector have conducted their framing inspections and approved all buildings (including community facilities); and

    (c) the outstanding balance on the first-tier construction financing exceeds the total state credit amount (the entire refund must be used to pay down a portion of the then existing construction debt).

Applicants must indicate which of the two options will apply to the project as part of the full application process; such decision may not be changed for the carryover allocation. Ownership entities will have to fully comply with the Plan, including Section VII(A)(2), to be eligible for participation in the state tax credit program. The Agency may adopt other policies regarding the state tax credit after adoption of the Plan. Owners, partners, members, developers or other Principals (and their affiliated entities) that are involved in a violation of any state tax credit requirement or fail to place a project in service after taking a loan or refund may, in the Agency's discretion, be assessed up to forty (-40) negative points or disqualified from participation in Agency programs.

CHAPTER 105
NORTH CAROLINA GENERAL STATUTES

Article 3E.
Low-Income Housing Tax Credits.

§ 105-129.40. Definitions applicable to Article.

The definitions in section 42 of the Code and the following definitions apply in this Article:

(1) Housing Finance Agency. – The North Carolina Housing Finance Agency established in G.S. 122A-4.

(2) Pass-Through Entity. – Defined in G.S. 105-129.35.

§ 105-129.42. Credit for low-income housing awarded a federal credit allocation on or after January 1, 2003.

(a) Definitions. – The following definitions apply in this section:

(1) Qualified Allocation Plan. – The plan governing the allocation of federal low-income housing tax credits for a particular year, as approved by the Governor after a public hearing and publication in the North Carolina Register.

(2) Qualified North Carolina Low-Income Housing Development. – A qualified low-income project or building that is allocated a federal tax credit under section 42(h)(1) of the Code and is described in subsection (c) of this section.

(3) Qualified Residential Unit. – A housing unit that meets the requirements of section 42 of the Code.

(b) Credit. – A taxpayer who is allocated a federal low-income housing tax credit under section 42 of the Code to construct or substantially rehabilitate a qualified North Carolina low-income housing development is allowed a credit equal to a percentage of the development's eligible basis, as determined pursuant to section 42(d) of the Code. For the purpose of this section, eligible basis is calculated based on the information contained in the carryover allocation and is not recalculated to reflect subsequent increases or decreases. No credit is allowed for a development that uses tax-exempt bond financing.

(c) Developments and Amounts. – The following table sets out the housing developments that are qualified North Carolina low-income housing developments and are allowed a credit under this section. The table also sets out the percentage of the development's eligible basis for which a credit is allowed. The designation of a county or city as Low Income, Moderate Income, or High Income and determinations of affordability are made by the Housing Finance Agency in accordance with the Qualified Allocation Plan in effect as of the time the federal credit is allocated. A change in the income designation of a county or city after a federal credit is allocated does not affect the percentage of the developer's eligible basis for which a credit is allowed. The affordability requirements set out in the chart apply for the duration of the federal tax credit compliance period. If in any year a taxpayer fails to meet these affordability requirements, the credit is forfeited under subsection (h) of this section.

Type of Development	Percentage of Basis for Which Credit Is Allowed
Forty percent (40%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of area median income and the units are in a Low-Income county or city.	Thirty percent (30%)
Fifty percent (50%) of the qualified residential units are affordable to households whose income is fifty percent (50%) or less of the area median income and the units are in a Moderate-Income county or city.	Twenty percent (20%)
Fifty percent (50%) of the qualified residential units are affordable to households whose income is forty percent (40%) or less of the area median income and the units are in a High-Income county or city.	Ten percent (10%)
Twenty-five percent (25%) of the qualified residential units are affordable to households whose income is thirty percent (30%) or less of the area median income and the units are in a High-Income county or city.	Ten percent (10%)

(d) Election. – When a taxpayer to whom a federal low-income housing credit is allocated submits to the Housing Finance Agency a request to receive a carryover allocation for that credit, the taxpayer must elect a method for receiving the tax credit allowed by this section. A taxpayer may elect to receive the credit in the form of either a direct tax refund or a loan generated by transferring the credit to the Housing Finance Agency. Neither a direct tax refund nor a loan received as the result of the transfer of the credit is considered taxable income under this Chapter.

Under the direct tax refund method, a taxpayer elects to apply the credit allowed by this section to the taxpayer's liability under Article 4 of this Chapter. If the credit allowed by this section exceeds the amount of tax imposed by Article 4 for the taxable year, reduced by the sum of all other credits allowable, the Secretary must refund the excess. In computing the amount of tax against which multiple credits are allowed, nonrefundable credits are subtracted before this credit. The provisions that apply to an overpayment of tax apply to the refundable excess of a credit allowed under this section.

Under the loan method, a taxpayer elects to transfer the credit allowed by this section to the Housing Finance Agency and receive a loan from that Agency for the amount of the credit. The terms of the loan are specified by the Housing Finance Agency in accordance with the Qualified Allocation Plan.

(e) Exception When No Carryover. – If a taxpayer does not submit to the Housing Finance Agency a request to receive a carryover allocation, the taxpayer must elect the method for receiving the credit allowed by this section when the taxpayer submits to the Agency federal Form 8609. A taxpayer to whom this subsection applies claims the credit for the taxable year in which the taxpayer submits federal Form 8609.

(f) Pass-Through Entity. – Notwithstanding the provisions of G.S. 105-131.8 and G.S. 105-269.15, a pass-through entity that qualifies for the credit provided in this Article does not distribute the credit among any of its owners. The pass-through entity is considered the taxpayer for purposes of claiming the credit allowed by this Article. If a return filed by a pass-through entity indicates that the entity is paying tax on behalf of the owners of the entity, the credit allowed under this Article does not affect the entity's payment of tax on behalf of its owners.

(g) Return and Payment. – A taxpayer may claim the credit allowed by this section on a return filed for the taxable year in which the taxpayer receives a carryover allocation of a federal low-income housing credit. The return must state the name and location of the qualified low-income housing development for which the credit is claimed.

If a taxpayer chooses the loan method for receiving the credit allowed under this section, the Secretary must transfer to the Housing Finance Agency the amount of credit allowed the taxpayer. The Agency must loan the taxpayer the amount of the credit on terms consistent with the Qualified Allocation Plan. The Housing Finance Agency is not required to make a loan to a qualified North Carolina low-income housing development until the Secretary transfers the credit amount to the Agency.

If the taxpayer chooses the direct tax refund method for receiving the credit allowed under this section, the Secretary must transfer to the Housing Finance Agency the refundable excess of the credit allowed the taxpayer. The Agency holds the refund due the taxpayer in escrow, with no interest accruing to the taxpayer during the escrow period. The Agency must release the refund to the taxpayer upon the occurrence of the earlier of the following:

(1) The Agency determines that the taxpayer has complied with the Qualified Allocation Plan and has completed at least fifty percent (50%) of the activities included in the development's eligible basis.

(2) Within 30 days after the development is placed in service date.

(h) Forfeiture. – A taxpayer that receives a credit under this section must immediately report any recapture event under section 42 of the Code to the Housing Finance Agency. If the taxpayer or any of its owners are required under section 42(j) of the Code to recapture all or part of a federal credit with respect to a qualified North Carolina low-income development, the taxpayer forfeits the corresponding part of the credit allowed under this section. This requirement does not apply in the following circumstances:

(1) When the recapture of part or all of the federal credit is the result of an event that occurs in the sixth or a subsequent calendar year after the calendar year in which the development was awarded a federal credit allocation.

(2) The taxpayer elected to transfer the credit allowed by this section to the Housing Finance Agency.

(i) Liability From Forfeiture. – A taxpayer that forfeits all or part of the credit allowed under this section is liable for all past taxes avoided and any refund claimed as a result of the credit plus interest at the rate established under G.S. 105-241.1(i). The interest rate is computed from the date the Secretary transferred the credit amount to the Housing Finance Agency. The past taxes, refund, and interest are due 30 days after the date the credit is forfeited. A taxpayer that fails to pay the taxes, refund, and interest by the due date is subject to the penalties provided in G.S. 105-236.